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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. 503

PALM SPRINGS HOLDING CORPORATION, *Petitioner*,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF AMICUS CURIAE OF STATE OF OHIO.

THOMAS J. HERBERT,
Attorney General of Ohio.

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On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF AS AMICUS CURIAE FOR STATE OF OHIO.

On behalf of thousands of holders of insurance policies issued by American Insurance Union, organized under the Fraternal Insurance law of Ohio, in the State of Ohio and in twenty-seven other States, the State, through its Superintendent of Insurance, is vitally interested in the outcome of the case at bar as well as the *Southwest Consolidated Corporation* case, Docket No. 286, and *Alabama Asphaltic Limestone Company* case, Docket No. 328.

Reasons for this interest may be found in the testimony on his behalf on pages 479 to 486 of the House Hearings on the Revenue Act of 1941 (Note also the testimony in the Senate Hearings, pages 234 and 235).

The Superintendent of Insurance of Ohio and the Attorney General as his Counsel, in drafting the plan to reorganize the property of the American Insurance Union, relied upon the construction of Reorganization, Sections 112 *et seq.*, of the Revenue Act, as contended for by the United States Department of Justice, in the *Kitselman* case, (see quotations in respondent's brief in *Alabama Asphaltic* case, Docket 328—Pages 14-16), which was adopted by the Seventh Circuit Court of Appeals (89 Fed. 2d 458), in which the court denied certiorari (302 U. S. 709). The Government now repudiates its own construction there approved by the court to the great prejudice of those represented by the Superintendent of Insurance in that if this Court now confirms the Government's repudiation, the common stock of the transferee, held by the Superintendent for the Policyholders, will have little or no value because without the predecessor's basis for depreciation (to which the Government said it was entitled under the rule of the *Kitselman* case), its earnings are taken to pay income and excess profits taxes.

The Treasury has suggested to members of the Ways & Means and Senate Finance Committees that no legislation be considered until this case and its companion cases are decided by this court because their decision might render legislation unnecessary.

The Court's attention is directed to the following points:

Point I.

By uniform Treasury rulings and court decisions holding a tax-free reorganization took place in which neither gain nor loss was recognized for the purpose of the United States Income Tax Law, losses in hundreds of reorganizations have been denied to bond-holders. The Commission

did not claim these decisions were erroneous until long after the Statute of Limitations barred the bond-holders' rights to deduct these losses. In other words, so far as such an agreement is possible, these bond-holder-taxpayers and the Bureau of Internal Revenue agreed upon the basis of the assets in the hands of the transferee corporation (such as Petitioner here) at the time of these reorganizations, made necessary by the economic depression, following 1929. The price the bond-holder-taxpayers paid for that agreement was inability to deduct their large losses. Now that this price cannot be regained by or returned to them, because of the bar of the period of limitations, the Revenue Bureau appears to seek to repudiate this so-called agreement.

Point II.

The consequences of upholding the Government's contention in the case at bar may adversely affect the public revenue where taxes are based upon invested capital. Many reorganizations, under the then existing rulings, of very large corporations were carried on in the prosperity period from 1924 to 1929 when values were greatly enhanced. Under the present excess profits tax the invested capital base as well as basis for other purposes is that of the transferor—if they were so-called tax-free reorganizations. An unduly restrictive construction of the word at this time will make it appear many of them were not reorganizations and enable them to step up the basis of the property acquired for all purposes. The rule cuts both ways. (*La Belle Iron Works* v. *United States*, 256 U. S. 377, 385, shows the value of the property was about $10,000,000 more than the stockholders had invested.) Obviously if the scope of this statute is now narrowed by the unduly restrictive construction of the word "reorganization," a very wide door will be opened to stepping up values for invested capital purposes for those corporations reorganized during the boom period of the 1920 decade as they can use the appreciated values at the time of reorganization instead of the

restricted predecessor's value. I. R. C. Sec. 718(a)(2), 113(a) 7, 113(b) 2. This is a time when the interest of the revenue demands a liberal construction of this Statute. For some cases construing it under the profits tax provisions of the first World War see page 7 of petitioner's reply brief herein. The Treasury is now urging before Congress that the invested capital base be the sole basis for credit against the 1940 excess profits tax law. Therefore, now this Court should not grant a loophole to the great corporate taxpayers to boost their invested capital by taking advantage of the high market values in the 1920 decade where such corporations were reorganized during that period. See Appendix for further explanation of this point.

Point III.

The effects of upholding the government's contention will be very sweeping and produce unjust results. One concrete example appears in the speech of Representative Paddock, in the House of Representatives, quoted in Appendix A of the reply brief for the petitioner herein which your honors are requested to read.

Point IV.

It has come to our attention that regulations 71, Article 125, promulgated by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury in July, 1932, construing the stamp tax provisions of the Revenue Act, under the caption "Definitions," reads as follows:

> "The term 'reorganization' in general, includes those business arrangements whereby the stocks and bonds of a corporation are readjusted as to amount, income, or priority, or the property is sold to a new corporation for new stock and bonds, *or is sold by the foreclosure of a mortgage upon it to the purchaser who buys for himself and his associates, and the various proceedings and transactions by which succession of corporations is brought about* and also the proceedings by which existing corporations are continued under a different organization without the creation of a new corporation"; (Italics ours.)

This regulation remained unchanged from 1932 until the issuance of new regulations in November, 1941. As pointed out at page 11 of respondent's brief in the Southwest Consolidated, Congress has reenacted or revised Revenue Acts nine times since 1932. While this regulation remained in force without making any change in it. *Cf. Helvering* v. *Winmill*, 305 U. S. 79, 83.

The Act did not exempt transfers of stock in reorganizations from stamp tax but did in Sec. 724 exempt transfers of bonds "in connection with a reorganization (as defined in section 112 of the Revenue Act of 1932)". (See petitioner's reply brief page 37.)

At the bottom of page 15 of its brief herein the Government states:

> "Regulations 77 under the Revenue Act of 1932 do not contain provisions material to the question in issue."

Surely this statement overlooks the relevant provisions of the regulations. For example Art. 574 of Regulations 77 states:

> "If two or more corporations reorganize, for example * * * the acquisition by the Y corporation * * * of substantially all the properties of the X corporation."

All the following regulations promulgated under the proceeding Revenue Acts, in which clause A of the definition was enacted in terms identical with the 1932 Act stated the acquisition by one corporation of substantially all the properties of another was a reorganization.

Art. 1574 of Reg. 65 (1924)
Art. 1574 of Reg. 69 (1926)
Art. 574 of Reg. 74 (1928)
Art. 574 of Reg. 77 (1932)

See also G. C. M. 1753 C. B. VI-1 p. 138 and G. C. M. 3827 C. B. VIII-2 p. 114. *National Pipe & Foundry Co.*, 19 B. T.

A. 242, 250. *Robert D. Green*, 24 B. T. A. 719, 725 (decided in 1931).

This background of administrative construction upholds the holding in *Minnesota Tea Co. v. Commissioner*, 76 F. (2d) 797 at p. 800 that Congress approved "the long continued administrative construction of the language of the definition".

Point V.

The Government here seeks to make the rule of *Le Tulle v. Scofield* work in reverse and apply it to the securities owned in the transferor immediately before the transfer (rather than to the securities received from the transferee as it was there announced). In that case the court said in 308 U. S. at page 420:

> "And where the consideration is represented by a substantial portion of stock, and the balance in bonds the total consideration received is exempt from tax under Secs. 112 (b)(4) and 112 (g) 45 Stat. 816, 818. Helvering v. Watts, 296 U. S. 387."

If it be assumed (but not conceded) that the rule works in reverse and applies to the nature of the interest exchanged, as the Government contends, nevertheless taxpayer in this case must prevail because its sole stockholder received a substantial part of the stock of the transferee. Hence we have here the reverse of the above quotation.

There is no support in the Statute for the claim that he must have received this stock in the transferee qua stockholder of the transferor corporation. (If he had, presumably the Government would concede a reorganization took place.)

It seems to us the Government's whole argument in the case at bar thus boils down to the claim that the case at bar is not a reorganization solely because the sole stockholder of the transferee did not receive these 1000 shares in the transferor qua stockholder of the transferee. For his services in the reorganization and his agreement to manage

taxpayer it was agreed, *before any stock was issued*, the sole stockholder of the old company would receive 1000 shares of taxpayer's stock to be issued and this agreement was duly performed. (R. 29) (See end page 5 of Government's brief)

Affiliated with this point is the claim in note 3 on page 9 of its brief that "In fact control within the statutory definition was not even in the participating creditors". (What it means here is qua creditors.). The statement of facts on page 5 of the government's brief shows all petitioner's stock, except the 1000 common shares (out of 7500 shares) issued to the sole stockholder of the transferor was issued to creditors of the insolvent transferor. More than 80 per cent thereof was issued to these creditors.

True it is the largest bondholder of the transferor (who owned more than one third of its bonds) received most of its common stock for new money but the unalterable fact is that the creditors of the transferor and its sole stockholder were in control of the property before and after the transfer. The bondholders alone received over 80 per cent of the stock of the transferee. No new people came in. Not a single share was issued to any person who did not own securities in the transferor. The words "the same persons or *any of them*" are very broad and the government's contention that the test is whether 50 per cent new people come in has been upheld. *Monarch Electric & Wire Co. v. Commissioner*, 38 F. (2d) 417 (C. C. A. 7th); *Fairbanks Court v. Commissioner*, 84 F. (2d) 17; cer. den. 299 U. S. 582. The Statute does not require that control be received in exchange for the property transferred. If it did it could be easily avoided.

The Government's Contention That There Can Be No Reorganization Under Sec. 112 i (1) of the 1932 Act Unless the Stock of the Transferor is in Substance Exchanged for Stock of the Transferee Cannot Be Upheld Without Altering the Plain Words of the Statute.

The 1932 Statute is quoted on page 13 of petitioner's reply brief. It does not say what the above heading says, yet the Government in effect asks the court to say it does by contending that the interest transferred must be solely a shareholder interest. Congress surely knew how to say that, if it had wanted to. We submit if the Treasury had asked it to so legislate it would have refused.

Even in 1934 when it changed this section (and its Committees stated they had changed it) it was only changed to require the transferee to issue voting stock for the assets of the transferor. This provision was not retroactive. It was not changed to require the transferee to issue such voting stock in exchange for stock of the transferor. Yet that is clearly the substantial effect of the change in it the Government asks this court to make by judicial decision. That is a power the Constitution grants to Congress alone.

No gain or loss is recognized under Section 112 (b)(5) where bonds are transferred to a corporation for its stock if immediately after the exchange the persons who transfer the bonds are in control of the transferee. *Leckie*, 37 B. T. A. 252.

The Government, referring to this on page 29 of its Southwest Consolidated brief correctly indicates the same legislative purpose underlies all these non-recognition provisions.

> "It is the same legislative purpose which, we believe, underlies the decisions that have developed judicially the rule requiring a continuity of interest."

We agree that the same purpose runs through all these non-recognition provisions and emphasize the importance of this point (see also section 112 (b)(3) quoted on page 30

of taxpayer's main brief) for we submit that the concession by the Government that the same purpose underlies them all coupled with the undoubted fact that a transfer of bonds to a corporation for not less than 80 per cent of its stock remains within the non-recognition provisions, destroys its whole argument in these cases—for if one may transfer bonds for stock and be within them, then surely one may transfer the economic interest the bonds represent and be within the policy underlying this legislation. It shows it is not the interest transferred but the interest at the conclusion of the transaction that decides the continuity of interest question.

Surely, if Congress had intended that stock alone or only the interest represented by stock of the transferor might be exchanged for stock of the transferee, it would have said so. No one in right mind would intend that and say "stocks or securities" might be exchanged as in sec. 112 (b)(3) or "property" as in sec. 112 (b)(5).

So far as we can discover administrative rulings have always been uniform that an exchange of bonds for stock of a corporation is a non taxable transaction if the persons making the exchange control the transferee immediately thereafter. *Leckie*, 37 B. T. A. 252.

Also all decisions agree that there need not be a continuity of the same interest. In *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378, the court said: (page 386) "True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the statute". See also *Hartzell*, 40 B. T. A. 492. This is obvious from the fact that the statute says a recapitalization is a reorganization and in a recapitalization bonds may be changed to stock. (See Committee report quoted on page 32 of taxpayer's main brief.) *Cf. Hoagland Co.* v. *Helvering*, 121 F. (2d) 962 where bonds were replaced by stock. Preferred stock may be changed for common. *Muchnic*, 29 B. T. A. 163. In these cases the same interest is not continued. This negatives the Government's contention that the change of bonds into stock destroys the continuity of interest.

On page 24 of its brief in the *Southwest Consolidated* case the Government states: "It may be assumed that clause E means no more than it says". Although taxpayer here says the same about every clause in the Statute, it will undoubtedly heartily concur in this statement as to Clause E. (Clause D in 1932 Act, involved in this case) which says a reorganization is a "mere change in * * * place of organization, however effected". (See pages 14, 19, 20 of taxpayer's reply brief.) The new corporation organized under the California law possessed the same assets as the old one organized under the Nevada law (The El Mirador Hotel) and the sole stockholder and bondholders of the Nevada company were interested in the new company. The words "however effected" embrace the way in which the change was effected in the case at bar and any other way.

CONCLUSION.

Corporations emerging from insolvency and their security holders have a hard enough struggle to survive without having the additional burden of an unjust result saddled upon them.

The decision of the Board of Tax Appeals should be affirmed.

All of which is respectfully submitted.

THOMAS J. HERBERT,
Attorney General of Ohio.

APPENDIX.

The purpose of this appendix is to explain Point II in more detail to the Court, the effect under the existing excess-profits tax law of 1940 of narrowing the definition of reorganization by judicial construction.

Section 718(a)(2) of the Code defines invested capital as follows:

> "Property (other than money) previously paid in (regardless of the time paid in) for stock, * * *. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange * * *."

The basis of property on sale or exchange is cost (Section 113(a)) unless it is within one of the exceptions in Section 113 such as the reorganization exceptions.

During the boom period from 1923 to early in 1929 thousands of companies were reorganized. In nearly all these cases the property was worth more at date of reorganization than at any other time. Consider alone the vast utility systems formed during this period and the then market value of their stock. If it is *now* decided in the cases at bar that the rules defining a reorganization, which existed during that period, were erroneous and that no reorganization took place because the stock of the transferee was acquired in exchange for bonds, these companies are not within the reorganization exception which limits the basis of property to that of the predecessor corporation, but cost becomes the basis. The cost is the fair market value of the stock issued for the property at the time of its issuance. Consequently, all these taxpayer companies organized during these boom years can now use these inflated values as the basis of their invested capital upon which present excess profits taxes largely depend.

These inflated values also become the basis for depreciation and for computing profit on subsequent sale of the property or increase loss on subsequent sale or exchange. Also the basis to the security holder is stepped up.

Effect of Rule of Le Tulle v. Scofield.

From 1923 to shortly before the time of the decision in *LeTulle* v. *Scofield*, transactions, such as there involved, were considered to be reorganizations. For the foregoing reasons the decision that they were not reorganizations is likely to prove more costly than advantageous to the revenue. This further indicates the rule in *Le Tulle* v. *Scofield* should not be extended.

Illustration: A building and land cost a corporation $500,000 in 1913. In January, 1929, its fair market value was $3,000,000. At that time these assets were acquired by a new corporation in what was then considered a nontaxable reorganization ("acquisition by one corporation of substantially all the properties of another"). They were acquired for bonds issued by the new corporation having a fair market value of $3,000,000 at the time of acquisition. In 1940 it appeared from the judicial decision in the *Le Tulle* case the 1929 acquisition by the new company was not in a reorganization. The result is instead of $500,000, the basis to the acquiring corporation becomes $3,000,000 for invested capital credit under the excess profits tax law of 1940, for depreciation and computation of profit or loss on subsequent sale or exchange.

This is because, not being a reorganization, the basis is not restricted to that of the preceding owner, but becomes cost to the new company, which is the fair market value of the bonds issued for the property of $3,000,000. The acquisition having been considered a reorganization in 1929, those receiving the bonds were not taxed thereon. The limitation on the right to tax them on the profit ran in 1932.

As a result they take in the aggregate a basis of $3,000,000 for computing profit and loss.

This example indicates what follows from overturning concepts of reorganization which prevailed in years outlawed as to most taxpayers.

In *American Light & Traction Company*, 41 B. T. A. 1121, the Commissioner lost a deficiency of $859,884.77 because his holding in that case that there was a reorganization in 1928 appeared erroneous under the rule of *Le Tulle* v. *Scofield* and the basis was accordingly stepped up. See 41 B. T. A. 1121, 1124.

SUPREME COURT OF THE UNITED STATES.

No. 503.—October Term, 1941.

Palm Springs Holding Corporation, Petitioner, *vs.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[February 2, 1942.]

Mr. Justice Douglas delivered the opinion of the Court.

This case is a companion case to *Helvering* v. *Alabama Asphaltic Limestone Co.*, No. 328, decided this day. This, too, was an insolvency reorganization, though a different procedure was employed to consummate it. The old corporation had outstanding about $300,000 face amount of first mortgage bonds, secured by a lien on its realty. The property, which was an hotel, was leased to an operating company. In 1931, as a result of transactions not relevant here, one Pinney became the sole stockholder of the old corporation and of the operating company. The furniture and fixtures in the hotel were owned by the operating company. They were covered by a chattel mortgage which, together with the lease on the hotel, were assigned and pledged as part of the security for the bond issue. In 1931 both companies were in financial difficulties and insolvent, at least in the equity sense. A bondholders' committee was formed which received deposits of more than half of the face amount of the bonds. Petitioner was formed in 1932. Pursuant to the plan of reorganization six shares of petitioner's preferred stock and four shares of its common stock were issued to assenting bondholders for each $1000 bond. In addition all of petitioner's remaining common stock was issued to one Lacoe in return for his agreement to pay the costs of incorporating petitioner up to $1000 and for his agreement to lend money to petitioner. Before the actual issuance of any of the shares, Lacoe agreed to transfer 1,000 shares of the common stock to Pinney, the sole stockholder of the two companies, for his services in the reorganization and as an inducement to him to continue as manager of the hotel. None of the stock of petitioner, however, was issued to any stockholder or former stockholder of either of

the companies for any rights any of them had as stockholders. In May, 1932, the indenture trustee declared the principal of the bonds due and payable. Pursuant to the terms of the indenture, the trustee sold all of the properties of the old corporation, including the lease and chattel mortgage, to petitioner, the highest bidder. The bid price was $61,800. It was satisfied by the payment of about $18,700 in cash and by the delivery to the trustee of bonds of a face amount of $292,000 for the balance. Foreclosure proceedings against the old corporation and the operating company were then instituted. At the foreclosure sale the furniture and fixtures, comprising all of the property of the operating company, were bought in by petitioner.

The Commissioner, in determining a deficiency in petitioner's income and excess profits tax for the fiscal year ended May 31, 1936, disallowed depreciation deductions on both the realty and personal property on the basis of cost to the old corporation and operating company.[1] He used as the basis the cost of the assets to petitioner plus the cost of additions. The Board of Tax Appeals sustained the Commissioner's determination with respect to the personal property but rejected it with respect to the realty. The Circuit Court of Appeals sustained the Commissioner on both points. 119 F. 2d 846.

Though the petition for certiorari raised the question, petitioner now concedes that the acquisition of the furniture and fixtures

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[1] Sec. 113(a)(7) of the 1932 Act (47 Stat. 169, 198) provides in part:

"(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

. . . . . .

"(7) *Transfers to corporation where control of property remains in same persons.*—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."

That provision is applicable here. See, § 114(a), § 113(b), § 113(a)(12) of the Revenue Act of 1934, 48 Stat. 680. The property here involved was acquired after February 28, 1913, in a taxable year prior to January 1, 1934, as required by § 113(a)(12). Respondent argues that this transaction was not a "reorganization" within the meaning of § 113(a)(7). And he points out that "control" was not in the participating creditors since the majority of the new common stock had been distributed, for a consideration other than an exchange of bonds, to Lacoe and Pinney. But he does not contend that assuming there was a "reorganization", an "interest" in the property of 50 per cent or more did not remain in the same persons (the bondholders) immediately after the transfer.

from the operating company was not a "reorganization" within the meaning of § 112(i)(1)(A) of the Revenue Act of 1932. So we do not reach that issue. As respects the assets acquired from the old corporation, we think there was a "reorganization" within the meaning of § 112(i)(1)(A) of the 1932 Act. That provision is the same in the 1932 Act as in the 1928 Act which was involved in *Helvering* v. *Alabama Asphaltic Limestone Co., supra.* That case is determinative of this controversy. The transaction fits the literal language of the statute. The new corporation acquired the assets directly at the trustee's and the foreclosure sales. The legal procedure employed by the creditors is not material. The critical facts are that the old corporation was insolvent and that its creditors took steps to obtain effective command over its property. For the reasons stated in *Helvering* v. *Alabama Asphaltic Limestone Co., supra,* the creditors at that time acquired the equivalent of the proprietary interest of the old equity owner. Accordingly, the continuity of interest test is satisfied.

Reversed.

Mr. Justice ROBERTS did not participate in the consideration or decision of this case.

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Test:

Clerk, Supreme Court, U. S.